

## **Tips for Competitive Payment Terms in Global Markets: The U.S. Small Business Administration Has Help for Small Exporters**

*by Inga Fisher Williams*

When the Monte dei Paschi Bank of Sienna, the fourth largest bank in Italy today, issued the first Letter of Credit in 1646, it could not have anticipated the role that this financial instrument would come to play in global trade. According to the World Trade Organization (WTO), the dollar volume of trade has doubled in the last decade and quadrupled over the past 20 years. The volume of international payment advisories routed through banks is now around one and a half billion a year and growing. Letters of Credit (LC) have evolved and adapted over hundreds of years; they are a recognized and well-known tool in processing international payments. Their importance is undisputed, although today they are no longer the only method for settling international accounts and often may not even be the one best-suited. As technology and competitive factors erode the volume of their use, letters of credit are nevertheless known even to the most unseasoned small exporter. Small exporters' contribution to U.S. trade is around 30 percent of total U.S. exports, which reached \$1.6 trillion in 2007. With around \$500 billion worth of annual exports, small U.S. businesses are players in the global market. They may not have at their command all the details of the UCP 600 (revised rules for letters of credit that became effective January 2006). Nor may they be knowledgeable in how to structure an LC properly so that risk is truly mitigated. But after open account terms, the LC is their favorite means of getting paid for export sales. Lacking information about alternatives, how can small firms adapt their practices to the modern market?

To be fair, the knowledge related to established practices and terminology of export financing is not integrated in the United States in nearly the same degree and at all levels of business as it is in European countries, where exporting has been practiced for profit — and as a survival technique — for decades. Globalization, however, has thrown small businesses into this arena for good. It's sink or swim, and, thanks to the Small Business Administration (SBA) export finance staff distributed across the country in regional [U.S. Export Assistance Centers](#), there is a life preserver. Small exporters can get help from SBA in learning about [key ingredients](#) for success in international trade and what *is* important in the practice of using a 350-year old convention for settling international accounts.

### **How To Get Paid**

It is not uncommon for small businesses to begin exporting in response to an unsolicited inquiry, not by any design or plan. How to get paid is one of the central, immediate questions for start-up exporters. Because they are inexperienced in export practices and risk-averse, they frequently opt for getting paid in advance. But there are other options.

Trade transactions are usually divided into traditional (LC, documentary collections, etc.) and open account terms. The LC, formally a "documentary Letter of Credit," is estimated to be used today in 10-12% of international settlements arranged through banks. When an LC is used, the buyer's bank steps into the place of the payment risk of the importer and promises payment, if the exporter abides by the terms and conditions of the Letter of Credit. Since it is essentially a bank-to-bank transaction, the LC language is designed and formed by bankers. Knowing how to "read" an LC and how to advise the buyer on the preferred structure and language is a technical skill that used to be provided by the international trade services division of major banks. However, amid the consolidation of the banking industry, pressures for market share and profitability, and the centralization of services, the formerly customary "call-your-local-banker" method for finding this information is likely to fail. Small businesses' access to LC guidance from the international divisions of trade banks has largely disappeared. But SBA's export finance staff in the Export Assistance Centers are able to fill this advice gap. Aside from the technical aspects of using an LC, SBA staff can also help an export business focus its use of LCs on suitable customers and current country risk. As a traditional risk mitigation tool, LCs are a payment method well-suited to first-time customers, sizeable transactions, and markets with a less-developed platform for credit checks or payment infrastructure.

## LCs in the Digital Age

LCs' diminishing share of international payments is a trend that still continues. In early 2007, SWIFT ([Society for Worldwide Interbank Financial Telecommunication](#), which provides a bank platform for secure communications) trade volumes overall increased 15%, while the SWIFT trade volume for LCs rose only 2.4%. As a bank-to-bank process, LCs are subject to the need for cost savings in operations, which drives the move toward digitization and high-speed telecommunication. In the last decade a great variety of "e-tools" has emerged to adapt LCs and international payment methods to the new high-tech world:

- *Bolero.net* built an infrastructure for the exchange of documents, aiming to eliminate the bane of LCs: discrepancies. It has also added some functionality for payments to its service.
- *Actrade*, the oldest of the innovators, started in 1987 by selling electronic trade acceptance drafts, targeting buyers who need trade credit.
- *Avantrust* began in 2001 as a joint venture of Dun & Bradstreet and AIG Insurance. It focused on providing credit approvals and assurance of payment in the electronic marketplace by offering a search for credit scores and combined that information with proprietary formulas for underwriting.
- *TradeCard*, with its strategic partner, Coface, and an alliance with MasterCard, began with a focus on trade between North America and Asia, expanding its global trade to Europe. Both the buyer and seller must be registered as users, and, as for many of the other tools, they must have invested in the necessary infrastructure to have access to the electronic platforms.
- *LC Connect* is also betting on the survival of the LC with its electronic process for soliciting bids and pricing from bank groups. LC Connect functions as a gateway and matchmaker to link companies with banks.

As banks embrace browser technology, the use of the LC may undergo continued makeovers. At this stage, the market is fragmented, and no clear winner for a standardized adaptation has emerged. For most small businesses, these innovations are not suitable or cost-effective due to the large up-front investment required to establish access to the proprietary platforms. The banking system itself will continue to undergo changes globally as market and regulatory mandates impact how it is structured. One European development to watch is SEPA (the Single European Payment Area), which took effect in January 2008 and will facilitate standardized payment instructions within 31 countries in the European region.

The move to open account terms has left banks with no real product and with shrinking opportunities for generating revenues. If it were possible to begin with a clean slate, how might process, platforms, and customs for payment tools and flows be designed today? Major issues of flexibility, security, regulatory compliance, efficiency, and speed may determine the shape of payment flows in the future. One use of the LC is certain to continue, if for no other reason than lack of an alternative. Standby Letters of Credit (SBLCs) remain very useful for down-payment guarantees and performance or bid bonds. There also is a trend to use LCs in the form of SBLCs in support of open account supply chain financing, mostly on the import side.

### A Nuanced Credit Policy Is a Must

Estimates in the industry are that 80 % of global trade is today conducted on open account terms. Evidence of the shift from letters of credit to open account is provided by the volume of messages in the SWIFT system. According to BAFT ([Bankers Association for Finance and Trade](#)), SWIFT payment volumes increased almost 75% in the 5 years from 2001 to 2006, from 929 million to nearly 1.6 billion, while SWIFT volumes tracking Letters of Credit remained relatively flat, growing by 10%, from around 43 million messages in 2001 to about 47 million in 2006.

Small businesses can leave much business on the table if they insist on Letters of Credit. In many emerging markets, their best trading partners may be too small or too new as a business to be able to muster the financial strength that LCs require. In well developed markets, furthermore, it is a distinct disadvantage to require an LC when the competition is offering open account terms. Even in markets where previously it was unthinkable to use anything but LCs (i.e., China), open account transactions are growing in popularity.

Exporters who use this trend to their advantage will open up their trade terms as a competitive sales strategy, while export companies that rely on one single payment term will find their sales prospects limited. A nuanced credit policy is a must. Its development needs to take into account internal factors, i.e., the financial strength of the company, its appetite for sales growth and risk exposure, and profit margins, and it should include parameters for offering extended terms that help sales staff in making appropriate offers. Ideally, the entire management team should be included in producing a set of standards for extending credit. Among external considerations, the company's global strategic position, competitive industry standards, buyers' preferences, regional standards, cost comparisons and convenience need to be factored in as well.

The role of credit risk insurance cannot be overlooked in this context. Foreign receivable insurance (see [www.sba.gov/idc/groups/public/documents/or\\_portland/or\\_exportcredits.pdf](http://www.sba.gov/idc/groups/public/documents/or_portland/or_exportcredits.pdf)), long accepted in Europe, has generally not been much used by U.S. companies in the past. Estimates are that over 40% of European exporters, but only 5–10% of U.S. exporters, utilize it. This lack of use can in part be attributed to the past dominance of U.S. traders in global markets and their ability to dictate terms. For the most part, however, it is simply not well known that credit insurance can mitigate the commercial and political risks of non-payment in export sales. This is beginning to change: the Export-Import Bank of the United States has reported that its Small Business Credit Policy is one of its fastest growing products. Available to SBA-defined small businesses with up to \$5 million in annual export credit sales, the Ex-Im Bank [policy](#) offers insurance for multiple buyers at very competitive rates. When it is combined with an SBA export working capital loan, Ex-Im Bank will discount the insurance premium by 25%, reducing the fee from 65 b.p. to 49 b.p. on the invoiced amount. The insurance industry's private sector providers, such as Coface, Atradius, AON, Euler Hermes, etc., have adapted to global market demands with modified, customized products that allow streamlined models for efficient mitigation of commercial and political risk. Lists of the specialized brokers for these products can be obtained from the SBA export finance staff in Export Assistance Centers.

Added benefits for the small businesses that use credit insurance come in the form of increased liquidity and competitiveness. The exclusion of foreign receivables from a firm's borrowing base — a long-established practice of banks in the United States — presents a handicap that many small exporters may not even be aware exists. They typically rely on a line of credit for working capital that may not be adequate to support the longer payment cycles of international transactions. Given current bank practices, the more the exporter's foreign sales grow, the greater the percentage of its receivables are deducted from what is often its principal business asset. Risk insurance turns receivables into a valuable asset, since banks are willing to lend against insured export receivables. Moreover, the competitive business posture of being able to meet industry terms is likely to play itself out in increased sales opportunities and volume for the small business.

### **Financing Growing Export Sales**

Access to financing consistently shows up among the top three obstacles to exporting, in nearly every survey of small businesses that could export but do not do so yet, or of firms that are in the early stages of their export development. The most common error of start-up exporters is to look for export financing in the international division of a bank. This intuitive approach runs counter to the evolution of U.S. banking structures, where these days the international divisions provide mainly trade service, i.e., services related to Letters of Credit, foreign exchange, hedging, etc. Although some of the larger banks still offer export / import lending in their international divisions, their customer focus is largely corporate and the preferred transactions typically on the larger side.

Loan-making for international transactions has largely shifted to the domestic side of the house in regional banks and, at community banks which lack an international division, that is where it has been all along, assuming the bank is willing to consider lending on transactions that are not domestic. The SBA has a well-developed distribution system of SBA lenders to aid early-stage exporters in finding a banking relationship that will support their expanding export sales. Moreover, with two export loan programs, the SBA has added capacity to its [financing support](#) of small businesses in the start-up and expansion stages.

Adequate working capital, a critical need for small emerging exporters, is frequently not considered until they are ready to sign the export contract. The demands of a longer cash cycle, inadequate supplier terms, and

limited cash from earnings or a line of credit, especially when combined with an insufficient track record to qualify for bank financing, will make the cash crunch apparent. The SBA [Export Working Capital \(EWCP\) loan program](#) is designed for just such a scenario. Whether needed as supplier financing, for the production of goods, or as working capital to support extended payment terms, these SBA guaranteed loans can provide up to \$2 million in financing for export sales. For smaller transactions or export expansion costs that are not eligible for EWCP financing, SBA is piloting its [EXPORT EXPRESS loan program](#), which has a \$250,000 loan maximum and has the advantage that its loans can be approved directly by participating SBA Express lenders.

### **SBA Offers Export Finance Expertise**

Touted as a One-Stop Shop for U.S. exporters, the U.S. Export Assistance Center network built on the platform of the offices of the [Commercial Service](#), U.S. Department of Commerce (DOC), has integrated SBA export finance specialists in 19 regional locations. For more than a decade, this joint venture of federal agencies has linked the marketing expertise of DOC trade specialists with the finance savvy of highly specialized SBA export finance staff. The infusion of finance expertise works on multiple levels: in integrated customer service to U.S. exporters, in inter-agency cross training and collaborative seminars, and in advocacy with community banks that have SBA divisions but are not yet offering export financing in their menu of SBA loans for small business customers.

A central aim of the Export Assistance Centers is to demystify international market entry, logistics, shipment documentation, and payment conventions. It is in the financial aspects of exporting that SBA staff make the difference. They not only are able to guide exporters through the SBA loan application process, if their internal working capital is not adequate, but are able to function like consultants to advise, teach, and pass on knowledge of emerging trends that help a small business position itself for success in global markets. Together with DOC colleagues and industry speakers, SBA export finance staff teach seminars where they share information regarding credit policy, due diligence practices and strategic consideration for negotiating terms, etc. — in short, all those tools that increase a company's expertise and expand its options in the decision-making process toward export expansion.

To find the SBA export finance staff for your state, consult the SBA's online [list of Export Assistance Centers](#).



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